

EMPLOY State-of-the-art Report

Unemployment and Activation

Martina Dieckhoff¹

Nuffield College, Oxford

mdi@sfi.dk

Unemployment is one of the most socially and economically damaging experiences for working age individuals. Research has shown that the association between unemployment and poverty risk is a virtually universal phenomenon amongst European countries (e.g. Martinez et al. 2001; Gallie and Paugam 2004). Likewise, many studies have confirmed the negative effects of unemployment on social participation (e.g. Paugam and Russell 2000), life-satisfaction (e.g. Whelan and McGinnity 2000), and emotional well-being (e.g. Kokko et al. 2000). Previous unemployment also negatively affects individuals' post-employment career trajectories: individuals who have experienced unemployment in the past are "scarred", they have a higher risk of future unemployment and earn less than otherwise equivalent individuals who have not experienced unemployment (e.g. Arulampalam 2001; Gangl 2006 forthcoming).

Unemployment has remained persistently high in many European countries, and within the EU as a whole unemployment has not fallen below 8 per cent since 1990. In light of its social and economic consequences and its threats to social cohesion, unemployment is understood to be one of the most important challenges for European policy-makers. In 1997 the EU Luxembourg Summit set up "Employment Guidelines" - which amongst other goals stress the need for a transition from passive to active labour market measures - and introduced "National Action Plans" with the function of member states reporting their progress against the guidelines (European Commission 1998).

Notwithstanding the high overall rate of unemployment within the EU, there exists a lot of cross-national diversity with some countries displaying very high rates of unemployment, whilst others have relatively low unemployment. Countries which have shown rather high unemployment rates since the beginning of the current century include Belgium, Finland,

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France, Germany, Greece, Italy and Spain. In 2003 unemployment rates in this group of countries ranged from 8.1 in Belgium to 11.3 in Spain. Relatively low unemployment rates are found in Austria, Denmark, Ireland, the Netherlands, Portugal, Sweden and the United Kingdom, where the 2003 unemployment rates ranged from 3.5 in the Netherlands to 6.4 in Portugal (OECD 2004; see also Saint-Paul 2004). Comparing the 2003 figures to the average unemployment rate between 1991 and 2001, unemployment has increased in three of the “old” EU-15 countries: Germany, Austria and Portugal (OECD 2004).

This section of the report provides an overview of recent research on unemployment which focused on the EU-15 countries. It concentrates on three different fields of enquiry. First, it reviews the literature on the social and economic consequences of unemployment. This is followed by an overview of the evaluation literature on labour market activation programmes. Finally, this part of the report discusses recent empirical work concerned with the phenomenon of “unemployment scarring”.

Social consequences of unemployment

The risk of poverty and social exclusion

Unemployment bears high personal and social costs for those affected by it. Research has shown that entry into unemployment is strongly associated with an increased risk of poverty (e.g. Moylan et al. 1984; Heady and Smyth 1989; Hauser and Nolan 2000; Gallie et al. 2003). In recent years, with harmonised European data having become available, research has started to investigate the social consequences of unemployment in a comparative perspective. This comparative work has attempted to discern the ways in which different welfare state arrangements but also different cultural contexts (e.g. with respect to the role of the family) may alleviate the risk of poverty and social exclusion for the unemployed.

Hauser and Nolan (2000) examine differences between a range of EU countries in the risk of poverty for the unemployed and the change therein between the mid 1980s and the mid 1990s. They analyse whether the risk of poverty for the unemployed differs across welfare state regimes. Following Gallie and Paugam (2000) they distinguish four “unemployment welfare regimes”: the universalistic regime with comprehensive coverage and a high level of replacement benefits (in this study represented by Denmark and Sweden), the employment-centred regime where coverage as well as level and duration of benefits are unequally distributed (Germany, the Netherlands, France), the liberal/minimal regime where both coverage and level of cover are incomprehensive (UK, Ireland), and the sub-protective regime

where coverage and level of cover are very incomprehensive (Italy). The analyses are based on national data sources, and show that, on average, poverty among the unemployed has increased between 4 to 7 percentage points over the period analysed. The exception is Denmark, where poverty rates among the unemployed have remained the same. Comparing the poverty rates of the unemployed with those of the population of working age, the poverty rates are – again with the exception of Denmark – in all countries higher for the unemployed. By the mid 1990s, this gap in poverty risk was extremely pronounced in Germany, the Netherlands, Italy, Sweden and the UK. The authors further examine the differential poverty risk for the short- and the long-term unemployed. With the notable exceptions of Sweden and Denmark, the long-term unemployed are in all countries more likely to experience poverty than the short-term unemployed. In sum, their findings suggest that countries belonging to the same welfare regime are quite heterogeneous regarding the poverty risks for the unemployed. Neither the extent of poverty nor the changes in poverty rates among the unemployed can be explained simply by the social policies in the different countries, though they help explain some cross-national variation. McGinnity (2004) conducts a comparative study of welfare arrangements for the unemployed and their implications for the experience of unemployment in Germany and the UK using the German Socioeconomic Panel (GSOEP) and the British Household Panel (BHPS). She finds that the British unemployed are much more at risk of income poverty than the German unemployed. Moreover, when examining those individuals who are employed one year and unemployed the next, she discovers that there is a greater fall in income in Britain than in Germany. These findings are in line with Gallie and Paugam's (2000) typology of unemployment welfare regimes which contends that liberal-minimal regimes like Britain are less effective in preventing poverty than the employment-centred system found in Germany.

Gallie et al. (2000) also investigate the relationship between unemployment and poverty risk. Their comparative study examines how the risk of poverty and financial hardship is distributed across different types of unemployed people and is based on data from the European Community Household Panel (ECHP). The authors predict particularly strong inequalities in the distribution of poverty risks amongst the unemployed in the employment-centred unemployment welfare regimes (as described above) compared to the universalistic ones. This is hypothesised because in the former regime type, unemployment benefits are strongly related to previous employment putting those with long career interruptions or those at the beginning of their labour market careers at disadvantage. The authors thus predict that young unemployed people and unemployed women in this regime would be particularly

disadvantaged. Their findings, however, would not corroborate this: whilst the findings suggest sex differences in poverty risks in some of the countries under study, these point to a greater vulnerability of men. Moreover, there is no evidence that type of welfare regime could explain the differential vulnerability of young people across countries. Their results confirm, however, that universal regimes provide relatively equal treatment to different groups of unemployed people. In Denmark and Sweden (both close to this ideal-typical regime) the risk of poverty for the unemployed is overall relatively low, and it is broadly similar across unemployed people with different individual and household characteristics. The authors further find that in all societies under study – with the exception of Denmark and Sweden – the extent to which an unemployed person is exposed to poverty and financial hardship depends on the nature of the household. Unemployed individuals who live alone or who live in households where none of the other adults are in employment have substantially higher poverty risks.

Another social consequence of unemployment is social isolation. Paugam and Russell (2000) study how unemployment affects the level of participation in social life in a comparative study based on ECHP data. Three spheres of sociability are distinguished: a primary (living alone or with others in the household), a secondary (meeting friends and relatives, neighbourhood sociability) and a tertiary sphere of sociability (membership in clubs and associations). The results indicate that in most Northern countries the unemployed are more likely to live alone, compared to their counterparts in stable jobs, whilst this is not the case in the Southern countries. Regarding secondary sociability of the unemployed, no clear pattern in terms of a North-South divide emerges. Regarding formal sociability (the tertiary sphere), the results suggest that the long-term unemployed in nearly all countries under study are significantly less likely to be a member of clubs or associations than those in stable jobs. Interestingly, in Denmark, the only country in the study close to a “universalistic” welfare regime, long-term unemployment did not have a significant effect on either the secondary nor the tertiary sphere of sociability. On the other end of the spectrum are Germany and France where unemployment appears to negatively affect sociability on all three spheres. Clearly, the social repercussions of reduced sociability on each of these spheres can vary substantially across countries. In the Southern countries where the tertiary level of sociability is less developed, a reduced level of formal participation of the unemployed is less disruptive compared to Northern countries where high overall levels of associational participation are found. Julkunen (2002) examines how longer-term youth unemployment affects both social deprivation (reduced sociability on the secondary and tertiary level) and material deprivation,

comparing Scotland and the Nordic countries (Sweden, Finland, Denmark, Norway and Iceland). Overall, the results show that the rate of both social and material deprivation for the long-term unemployed was highest in Scotland representing a liberal-minimal model of welfare, whilst the Nordic countries representing universalistic models of welfare were more effective in preventing deprivation of unemployed youth. However, the author found significant variation amongst the Nordic countries, with Denmark being by far the most successful in maintaining the living standards and levels of social participation of the unemployed. The analyses would suggest that it is not the coverage or levels of benefits that explain the differences amongst the Nordic countries, but other factors which the study could not control for. Moreover, the analyses point towards the importance of the family as a mediating factor. The effect of the family as an economic and social safety-net was stronger in Scotland than in the Nordic countries.

Research has also addressed the question how far unemployment leads to social exclusion. Social exclusion describes the mechanism whereby unemployment leads to poverty and social isolation, which in turn increase the risk of long-term unemployment. Gallie et al. (2003) examine the underlying dynamics of social exclusion longitudinally using the ECHP. An advantage of the longitudinal approach, in contrast to the cross-sectional one, is that it can make claims about the causal mechanisms of the social exclusion process. Their comparative study shows that moving from employment to unemployment leads to a significantly increased risk of poverty. The only exceptions are Denmark and the Netherlands, both welfare states with very generous and comprehensive benefits for the unemployed. However, the analyses did not reveal consistent evidence that unemployment leads to social isolation. Moreover, in line with the expectations of the social exclusion thesis, the results show very consistent negative effects of poverty on re-employment chances. By contrast, there is little evidence that social isolation does increase the time spent in unemployment. This work has thus shown that unemployment precipitates poverty, and that poverty is the key causal factor in the process of exclusion as it significantly increases the risk of long-term unemployment. Social isolation, however, does not contribute to the marginalization process (see also Gallie and Paugam 2004). Hammer (2000) reaches similar conclusions. She examines social exclusion amongst young unemployed youth in Scandinavia, comparing Sweden, Finland, Norway, Denmark and Iceland. The analyses are based on register data from these countries. Her results suggest that financial problems lead to increased probability of prolonged unemployment in all five countries. Social integration (measured by parental support, friend's

support, social contact, participation in organisations), however, does not appear to affect the odds of re-entering employment.

Life-satisfaction and mental well-being

Unemployment also impinges on individuals' life-satisfaction and mental well-being. Whilst this part of the State of the Art Report focuses only on recent contributions, it is noteworthy that earlier empirical evidence for many industrialized countries has consistently shown that unemployment is associated with lower levels of satisfaction and well-being (Clark and Oswald 1994 for the UK; Whelan et. al. 1998 for the UK and Ireland; Gerlach and Stephan 1996 for Germany; Korpi 1997 for youth in Sweden; cf. Oswald 1997 for a review for earlier work in this area of enquiry). This evidence would suggest that "unemployment appears to be the primary economic source of unhappiness" (Oswald 1997: 1828).

Whelan and McGinnity (2000) examine cross-national variation in the relative impact of unemployment on overall life-satisfaction in a comparative study based on ECHP data. Following Gallie and Russell (1998), they identify four factors which may lead to a stronger impact of unemployment on life-satisfaction in some countries than in others: the relative generosity of welfare systems, the level of unemployment, the composition of the unemployed, as well as the cultural importance of work. Their findings show that unemployment has a very strong negative effect on life-satisfaction in all countries under study, and that cross-national variance in the impact of unemployment is rather modest. The results indicated that the effect of unemployment is somewhat less pronounced in Denmark, Greece, and Spain, and for women in Ireland and the UK. This particular pattern of cross-national variation, however, does not appear to be explicable in terms of any of the four mediating contextual factors. What seems to be the main challenge regarding the effect of unemployment on satisfaction is to explain the consistent pattern across countries rather than the modest cross-country variance.

Alm (2001) studies the relationship between unemployment and mental ill-health symptoms using Swedish longitudinal data (the Longitudinal Study Among the Unemployed – LSA, and the Level of Living Survey – LNU). Her measures of mental ill-health focus on three symptoms: insomnia, nervous problems, and depression. Comparing the unemployed and the working population, she find that the unemployed were more likely to show all three mental ill-health symptoms under study. Her results further show a significant and positive relationship between unemployment duration and the incidence of depression. Her results further indicate that the receipt of unemployment insurance benefits is an important mediating

factor. A recent contribution by Nordenmark et al. (2006) is also concerned with the alleviating effects of unemployment benefits. They examine how the impact of unemployment on mental distress is mediated by different types unemployment benefit systems, comparing Sweden, Ireland and Great Britain. Previous research has shown that the main factor influencing mental well-being among the unemployed is economic situation (Whelan et al. 1991; Gallie 1999; Strandh 2000). The authors thus argue that the generosity of unemployment benefits may explain cross-national variation in the effect of unemployment on mental distress. Of the countries under study, Sweden presents a social policy context with generous income replacement benefits for the majority of the unemployed (which are related to previous income), where only a small proportion of the unemployed do not qualify for income replacement and receive flat-rates. By contrast, the benefits systems in the UK and Ireland are flat-rate. In both countries benefits are less generous and means tested for those without an employment history and time-limited for those with. Their analysis is based on representative longitudinal data from the three countries and uses the General Health Questionnaire measure of psychological distress. The analyses would suggest that receipt of income replacement benefits does significantly decrease distress in Sweden, whilst no positive effects of reciprocity of flat-rate benefits could be found for Ireland and the UK. Strandh (2001) examines the impact of state intervention on mental well-being among the unemployed in Sweden. The study draws on a large longitudinal data-set of unemployed people which was collected within the “Long-term Unemployment Project” (LUP). Regarding economic support for the unemployed he finds that access to unemployment benefits significantly reduces the negative impact of unemployment on mental well-being. By contrast, the less generous flat-rate cash benefits do not show any positive effects. Strandh also investigates the impact of active labour market policies on mental well-being of the unemployed. He distinguishes three types of measures: vocational training, activation, and workplace participation. Whilst in workplace participation the unemployed individual performs activities in a regular workplace, activation takes place outside the regular labour market and is carried out exclusively with other unemployed. The results suggest that of the three activation measures under study, only involvement in workplace training has a positive effect. Nordenmark (1999) examines the relationship between employment commitment and psychological well-being among Swedish unemployed. His findings, also based on the LUP data, show that unemployed individuals with a strong non-financial employment motivation have a significantly higher risk of experiencing poor mental well-being than the unemployed with lower commitment to employment.

Labour market activation

Whilst the Scandinavian countries, in particular Sweden² and Denmark, have a long-standing tradition of active labour market policies (ALMPs), international organisations such as the OECD (1994) and the EU have increasingly started to emphasise the need for an expansion and enhancement of the effectiveness of active labour market measures since the early-mid 90s. In 1997 the EU Luxembourg Jobs Summit underscored the need to re-balance public expenditure from passive to active measures (European Council 1997). It noted that all Member States should – together with the social partners – aim to guarantee training, retraining, work practice or a job to young unemployed individuals before reaching six months of unemployment. Unemployed adults should be offered such activation measures before reaching 12 months of unemployment. The final objective is to increase active labour market policies so that at least 20 per cent of the unemployed population would benefit from activation measures. How far these policy recommendations have been followed and resulted in increased efforts to activate the unemployed is unclear. Whilst social policy analysts have noted that in the last decade or so European welfare states have experienced a shift from “passive” to “active” labour market policies (e.g. Lødemel and Trickey 2001; Goul Andersen et al. 2002; Barbier and Ludwig-Mayerhofer 2004), actual public spending figures would suggest that money spent on active measures in absolute terms has in fact slowly decreased since 1993, from 1.12 per cent of GDP in 1993 to .99 in 2000 (Martin and Grubb 2001; see also Kluge and Schmidt 2002). At the same time, spending on activation as percentage of total spending on labour market policies has increased from 31 per cent to almost 40 per cent during this time (Martin and Grubb 2001, cf. table 1).

Training programmes for the unemployed or those at risk of unemployment are the most common category of active labour market programmes (Kluge and Schmidt 2002; see also Martin and Grubb 2001). However, subsidised employment (in both private and public sector) as well as job search assistance are also common activation measures (Kluge and Schmidt 2002). One focal characteristic of active labour market policies is that income protection entitlements of the unemployed are made increasingly dependent on their willingness to take up these activation offers (Lødemel and Trickey 2001; van Berkel and Hornemann Møller 2002; van Berkel and Hornemann Møller 2004).

The empirical research concerned with the quantitative assessment of the impact of activation programmes on individual’s future labour market prospects is often referred to as

² Sweden being the only country that in 1985 spent more on active than on passive measures (OECD 1994: 101)

“evaluation literature”. This literature normally uses unemployment (employment) duration or hazards, or unemployment (employment) rates, respectively as indicators of programme effectiveness (ibid.). Few studies also use wages as outcome variables. The findings of the evaluation literature are quite inconclusive, but would often suggest disappointing effects of activation programmes³. One of the challenges of research evaluating the impact of activation policies is to effectively control for selection bias. Those individuals who are selected or select themselves into labour market activation programmes may differ systematically from those who do not participate in their unobserved characteristics. They may be more (or less) motivated than their not participating unemployed counterparts, and they may be more (or less) successful in re-entering the labour market even in the absence of the activation programme. The empirical literature is very sophisticated in terms of econometric techniques applied, and the vast majority of the research in this field ensures that selection problems are controlled for. Most studies apply matching methods (cf. Kluve and Schmidt 2002 for a discussion of the “evaluation problem” and methodology requirements for this field of enquiry).

Reviewing the German literature on training programmes targeted at the unemployed shows how even research using the same data can arrive at very different conclusions regarding the efficacy of activation depending on the specific type of programme, the target group, but also on the econometric technique applied. Lechner (2000) examines the impact of public-sector sponsored vocational training on employment probabilities and earnings in East-Germany using the GSOEP and applying matching methods (Rosenbaum and Rubin 1983). He finds no long-term effects on employment probabilities or earnings. Pannenberg (1995) analyses the effect of vocational training on re-employment probabilities also using the GSOEP. The estimates of his discrete hazard rate models, by contrast, suggest positive effects on re-employment probabilities. These different findings may be due to the fact that Lechner (2000) focuses exclusively on public sector training, whilst this is not the case for Pannenberg (1995). Another reason could be the different techniques employed: matching methods are more effective in controlling for selection bias than event-history models. Evidence from Ireland shows that it is important to distinguish between different types of activation measures. O’Connell (2002) matches two individual-level data-sources: the FAS⁴ follow-up

³ In this report the focus is exclusively on research based on micro-data and concerned with the effects of these programmes on individuals future labour market attainment. For a comprehensive study analysing the effectiveness of active labour market policies at the macro-level, the interested reader may refer to Boone and van Ours (2004).

⁴ FAS is the *Training and Employment Authority*.

survey from 1996 which follows programme participants for a two-year period after they leave the programme and the Living of Ireland Survey for the comparison group. The author applies the Heckman selection correction method (Heckman 1979) and finds that specific skills training and employment subsidies to place unemployed workers in the private sector are the two types of programmes which significantly improve employment prospects of participants. By contrast, general training measures were only effective for certain groups, whilst community employment has no positive effect on subsequent employment. The findings of O'Connell's research would thus suggest that active labour market programmes with strong market linkages are more effective than measures with weaker market linkages. This conclusion seems to be confirmed also by Denny et al. (2000) who review a number of Irish programmes in terms of their effects of future employment chances and earnings and find that programmes with strong labour market linkages are more effective than those who have more general remits. Likewise Sianesi's (2001) findings reveal that activation measures "most similar to regular employment" tend to be more successful in re-integrating workers into the labour market (this is also in line with results obtained by Carling and Larsson (2001) who tested the relative efficiency of labour market programmes in Sweden). Sianesi uses a register-based longitudinal event-history data-set for the 1990s from the National Labour Market Board (AMS) and applies propensity score matching to examine a range of different activation programmes. Her results show that employment subsidies and training replacement are the most effective programmes. The latter refers to particular schemes in Sweden which entail both, training and work experience in a regular job. By contrast, formal vocational training as well as temporary relief work (which is predominantly located in the public sector) are not conducive to labour market re-integration. Brodaty et al. (2001) analyse youth employment programmes in France targeted at the most disadvantaged and unskilled young workers distinguishing workplace training programmes in the private sector and "workfare"-like programmes in the public sector. Using propensity score matching, they examine whether these programmes have a positive effect on the probability of employment. The authors find positive effects only for on-the-job training in the private sector. Using data from the British Labour Force Survey, Bell et al. (1999) examine the effects of the UK Government's New Deal for unemployed youth. Conducting trend-adjusted difference-in-differences analysis to examine the effect of temporary wage subsidies, they find only modest evidence that participant's productivity (as measured by their wages) increased with job duration. The participants' productivity if they remain in the job for a year is still far below the wage they are receiving and the author's conclude that the average participant will not be able to keep

the job once the wage subsidy runs out. Van den Berg and van der Klaauw (2006) analyse the impact of job search assistance aimed at unemployed workers with “relatively good labour market prospects” on unemployment duration in the Netherlands using experimental data from 1998 to 1999. The estimates of their duration models show no significant effects.

Kluve and Schmidt (2002) meta-analyse the results of previous European evaluation research to ascertain which programmes tend to be effective. The meta-analysis is based on earlier studies (on programmes before 1994) which were discussed in Heckman et al.’s (1999) extensive review of the evaluation literature as well as on more recent research. In total their meta-analysis is based on 53 evaluation studies (of which 28 report positive treatment effects). Kluve and Schmidt distinguish three types of programmes: subsidy-type schemes, training programmes, and job search assistance. The results of the meta-analysis would suggest that programmes with a large training content as well as job search programmes tend to most likely improve the probability of employment, whilst subsidy schemes tend to perform badly. Clearly this analysis should be understood to be of exploratory character given that it consists of only 53 evaluation studies and given that the estimated treatment parameters reported in these studies were derived “with differing methods and, presumably, scientific rigour” (ibid. 435). Unfortunately, their meta-analysis does not allow for the distinction between programmes which have stronger and weaker market linkages as it does neither distinguish between on-the-job training and more general training measures nor between subsidised employment in the private and public sector. Given the findings of the country studies presented above, it would have been interesting to ascertain whether the meta-study confirmed the finding that programmes with stronger market linkages are more effective to reintegrate the unemployed into the labour market.

One shortcoming of current evaluation studies is that there exists very little evidence on the long-term effects of activation programs, normally covering at most two years after the individual has participated in the programme. Evidence from the US based on evaluations following individuals for a longer period of time would suggest that benefits from programme participation tend to dissipate after four years (Grubb 1999; Holtz et al. 2000).

Unemployment scarring

Existing empirical research on the longer-term psychological and economic consequences of unemployment has provided strong evidence that an unemployment spell has persistent negative effects on individuals’ mental well-being and on their subsequent labour market

careers. Clark et al. (2001) provide evidence of the long-term psychological scars of unemployment. They examine how past unemployment spells affect well-being of those currently in work. The study draws on data coming from the GSOEP, covering the period from 1984 to 1994. The authors use responses to a question of overall life-satisfaction as a measure for psychological well-being. The analyses show that well-being is lower for those with past unemployment experiences (within the last three years), and that this effect is stronger for men than for women. Lucas et al. (2004) come to similar conclusions regarding the effect of past unemployment on current well-being. They use the same data-source as Clark et al. (2001), spanning the period from 1984 to 1998, and also employ the same measure of well-being. They find that the damaging effect of past unemployment on current well-being persists for many years after becoming re-employed. There are reasons to believe that the negative effect of past unemployment on the mental well-being of those currently in work can be explained by the quality of jobs held by people with previous unemployment. Gallie et al. (1998) show that those who previously experienced unemployment are less likely to be working in an economically advanced setting and in jobs with possibilities for self-development and in-career training. Moreover, the previously unemployed are more likely to be in precarious jobs with temporary contracts and lack of effective employee representation which is likely to impinge on their well-being.

Research concerned with the scarring effect of unemployment on subsequent labour market attainment has shown that previous unemployment experience does not only increase the likelihood of future unemployment, but it also leads to substantial losses in earnings, persisting even for years after the actual unemployment spell (Ruhm 1991). Individuals who experienced an unemployment spell are paid less and have a higher chance of future unemployment than an otherwise equivalent individual. One explanation as to why unemployment leaves such scars comes from human capital theory (Becker 1993 [1964]), which conjectures that job displacement incurs the permanent loss of firm-specific skills. At the same time an unemployment spell debar the accumulation of work experience, and may also bring the deterioration of general skills (Van Loo et al. 2001). Unemployment may also have scar effects as future employers understand previous displacement as signalling low productivity (Spence 1974).

While the bulk of research on the economic scars of unemployment comes from the US (e.g. Ruhm 1991; Jacobson et al. 1993; Farber 1997; Brand 2004), recent years have seen an increase in European research on the scar effects of unemployment (e.g. Arulampalam 2001;

Burda and Mertens 2001; Gregory and Jukes 2001), though the European literature remains limited.

Arulampalam (2001) examines the effects of unemployment spells on wages after re-entry into the labour market for men drawing on data coming from the British Household Panel Data. Applying Heckman's (1979) selection correction to control for possible selection bias, she finds that unemployment is associated with long-lasting negative effects on future wages. The wage loss increases with tenure with the new employer (from 6 per cent in the first year to 14 per cent in the fourth year), it then slowly declines and remains at the level of 11 per cent. Her findings further suggest, that it is the unemployment spell in itself that causes scarring, the duration of the unemployment spell does not affect the wage scar. Gregory and Jukes (2001) also examine the scar effect of unemployment in the UK using data coming from the New Earnings Survey Panel and the Joint Unemployment and Vacancies Operating System. The analyses are constrained to men, and the authors use Heckman's selection correction to account for selection bias. They find that an unemployment spell in the year before the survey leads to a wage decrease of 10 per cent after re-entry to the labour market. In contrast to Arulampalam (2001) they find that the scar effect decreases within the first years of tenures, and is at the level of 1.9 per cent after more than two years of employment. Moreover, the authors find – again in contrast to Arulampalam (2001) – that wage penalties vary directly with the length of the unemployment spell⁵. Burda and Mertens (2001) estimate wage scars of unemployment for German workers. They use the GSOEP and the social insurance file (IAB) and employ a range of different estimation procedures (including instrumental variables) to arrive at robust estimates. Overall their findings would suggest that the financial consequences differ significantly by workers' prior position in the wage distribution. Those in the lowest earning quartile even experience a slight wage growth of 2 per cent, whilst wage growth losses for the upper three quartiles are high (-17 per cent) and persist even 4 years following the unemployment spell.

These country studies on unemployment scarring are also complemented by comparative research. Layte et al. (2000) examine the effect of past unemployment on future labour market outcomes in a comparative study of Sweden, the Netherlands, Britain and Italy,

⁵ The reasons for these discrepancies between the two studies are discussed in Arulampalam et al. (2001: 581). Three potential reasons are suggested: 1.) Gregory and Jukes (2001) use a longer observation period starting in the mid 1980s when unemployment durations were long and early retirement not yet an option, whilst Arulampalam (2001) only covers the period of the 1990s; 2.) Gregory and Jukes examine only the registered unemployed whilst Arulampalam includes registered and unregistered unemployment; 3.) the sample used by Gregory and Jukes is considerably larger than Arulampalam's which may allow sharper definition.

using retrospective work history data from national surveys. The authors predict that active labour market policies prevalent in Sweden and the Netherlands may mitigate the scar effect of unemployment. The results of their event-history analyses would corroborate their predictions. The effect of past unemployment on future unemployment risk is substantially smaller in the Netherlands compared to Italy and the UK. In Sweden this effect is insignificant. Gangl (2006 forthcoming) also conducts a cross-national study on scar effects. He uses panel data from the US survey of Income and Program Participation (SIPP) and the ECHP to examine the effect of unemployment on future career prospects comparing 12 European countries as well as the US. In order to control for selection bias based on observables and unobservables the author applies difference-in-differences propensity score matching (Rosenbaum 2002) to examine the impact of past unemployment on re-entry wages. The author finds evidence for unemployment scarring in terms of lower wages in all countries under study. Gangl's results would suggest that the Scandinavian labour market institutions are most effective in mitigating the scar effect of unemployment: in Finland and Denmark, where we find a combination of flexible labour markets and generous unemployment benefits, the economic costs of unemployment were lowest. Somewhat surprisingly, the Mediterranean countries combining rigid labour market regulation and weakly developed welfare states fare second best. They are closely followed by the Continental European countries combining strong unemployment insurance with strongly regulated labour markets (through strict employment protection legislation). The liberal economies in the UK, Ireland and the US with weak unemployment insurance systems and almost non-existent employment protection legislation showed by far the strongest scar effects. Gangl's findings would thus suggest that institutional differences matter, and that both strict labour market regulation as well as generous unemployment benefits were correlated with low scarring.

Summary

The aim of this section of the report was to review the recent European literature on the consequences of unemployment for individuals. Three areas of enquiry have been reviewed: the field of research concerned with the social consequences of unemployment, evaluation research concerned with the effectiveness of labour market activation, and research on the scar effect of unemployment.

Research on the social consequences of unemployment has consistently shown that unemployment increases individuals' risk of poverty and material deprivation in nearly all of

the old EU countries. Poverty in turn makes it more difficult for the unemployed to get back into employment reinforcing the risk of long-term unemployment. There is also some empirical evidence which would suggest that unemployment leads to social isolation, but this finding is neither consistent across countries nor the different studies presented here. Research has also provided ample evidence that unemployment decreases life-satisfaction and psychological well-being. There is some indication that cross-country variation in the vulnerability of the unemployed to poverty may be explained by differences in their welfare regimes, with generous social policies (as found in Denmark) alleviating the negative consequences of unemployment. Regarding the negative impact of unemployment on mental well-being, however, the most striking finding is the consistency across countries.

Studies concerned with the evaluation of active labour market programmes provide mixed evidence. The literature reviewed revealed the limits of activation in re-integrating individuals into regular employment. It has been shown, however, that the type of programme matters. Programmes based on employment in a regular workplace and on-the-job training measures providing specific vocational skills were more effective than employment in artificially created jobs in the public sector or training which is more general in nature. The major shortcoming of evaluation research is that it currently provides very little information on the longer-term consequences of activation programmes. The time-frame under observation tends to be short, and studies which follow programme participants for more than two years are scarce. Therefore, current studies can say very little about the effectiveness of activation programmes in re-integrating the unemployed into sustainable employment.

Finally, the research on unemployment scarring has shown consistently that unemployment has negative effects on future careers. Even for years after becoming re-employed, formerly unemployed workers receive lower wages than their otherwise equivalent counterparts. Recent evidence would suggest significant cross-national variation in the extent of the wage scar which can be explained by differences in the labour market institutions regarding unemployment and employment protection. The evidence on scarring presented in this part of the report indicates how high the costs of unemployment really are. The depreciation of skills during interruptions to employment is generally understood to be a central dimension of wage scarring (e.g. Arulampalam et al. 2001). It is thus likely that active labour market policies providing the unemployed with real opportunities of skill maintenance through employment in regular work places or skills development through longer-term vocational on-the-job training could significantly mitigate scarring. To examine the potential

impact of such activation programmes on unemployment scarring, however, evaluation studies based on longer time frames than those found to date are needed.

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